EXCHANGE OF STOCK FOR CAPITALIZED PROFITS

THE judgment of Vice Chancellor Pitney in the somewhat recent case of *See* v. *Heppenheimer*[1] is of more than usual importance on account of the nature of the interests involved, and the advanced position taken on the perplexing question of watered stock. Extensive notes on the case have appeared in legal periodicals,[2] yet it would seem, in view of the doctrines announced, that more extensive comment will be profitable.

The particular case is one of a series of suits[3] growing out of the failure of the so-called "Straw Board Trust." In this particular case, See, as receiver of the Columbia Straw Paper Co., filed a bill to compel the defendants, stockholders in the corporation, to pay assessments on their stock to satisfy the claims of creditors of the corporation, on the ground that the stock held by the defendants had not been fully paid for. The suit is based primarily on a statute of New Jersey[4] providing that stockholders whose stock is not fully paid shall contribute such further sums up to the par value, as are needed to pay the debts of the corporation.

It appears from the evidence, and the court finds, that the corporation was promoted and organized by Messrs. Stein, Beard, and Untermeyer, and other parties, under their control and direction, under an agreement by which options were to be obtained on certain straw paper mills situated in the middle west; then a corporation was to be organized, under the laws of New Jersey, to take over the property covered by the options: each of the promoters before named was to raise one-third of the funds necessary to carry through the enterprise, and to receive one-third of the profits incident thereto, the law firm of which Untermeyer was a member to receive $50,000 for its services.

Pursuant to this agreement Stein obtained options in his own name on thirty-nine mills at an aggregate price of $3,000,000, payable, $750,000 cash, $750,000 preferred stock, and $1,500,000 in common stock. Eventually only $2,800,000 was actually paid, counting the common stock at par. The money paid was raised by selling the mortgage bonds ($1,000,000) at par, with two shares of preferred stock and four shares of common stock added as a bonus to each $1,000 bond. Most of the money was raised before the corporation was organized on the bonds issued, by means of a pros-

[1] 61 Atl. R. 843 (N. J.).

[2] 4 MICHIGAN LAW REVIEW, 220; 19 Harvard Law Review, 367.

[3] Northern Trust Co. *v.* Columbia Straw Paper Co., 75 Fed. R. 936; Dickerman *v.* Northern Trust Co., 176 U. S. 181 (foreclosure proceedings by bondholders).

[4] 1 Gen. St. of New Jersey, p. 910, sec. 5.

pectus prepared by Untermeyer which purported to set out the state of the straw paper industry, and the immense profits made possible by the consolidation. Mr. Untermeyer took $50,000 in bonds, with the stock bonus, in payment of the services of his firm, and with his friends $467,000 in bonds on the same basis. Mr. Stein raised his third by persuading mill owners to take bonds instead of cash, as provided in the options. The company was incorporated by Mr. Beard, Mr. Heppenheimer, a New Jersey attorney who usually assisted Mr. Untermeyer's firm in organizing New Jersey corporations, and Mr. Untermeyer's secretary. Each of the incorporators took four shares, and a share of stock was issued to each of six other persons, employees of Mr. Untermeyer. These persons elected themselves directors. To them was submitted a proposition, signed by Stein, to sell to the corporation the properties covered by the option for $5,000,000 to be paid, $1,800,000 in cash, $1,000,000 in preferred stock, $2,998,200 in common stock; a list of the mills was given, but the value or price of the individual properties was not indicated. The proposition was accepted at the stockholders' meeting by a resolution previously prepared, and a contract of purchase authorized. No investigation of any sort was made by the stockholders prior to the vote. The employees who were named as directors resigned within a week, and their places were filled by the election of stockholders who were former mill owners. The result of the transaction was that $1,000,000 of stock was divided equally between Stein, Beard and Untermeyer, without payment therefor.

The corporation launched its business, but speedily failed, and the mortgage bondholders absorbed the property, which from various causes was much depreciated. The court ruled that all the defendants who received stock as a bonus, or received it through Stein, under the promoter's agreement, were liable to the par value of the stock, or so much thereof as should be found necessary to meet outstanding obligations of the corporation. All holders of stock who "came in on the ground floor," that is, who received stock as a bonus with the bonds purchased, are treated as standing in the same position as original subscribers for stock.

On the findings of fact and law by the court, it would seem that the decision might rest, as far as the promoters and their privies are concerned, on the proposition that the sale to the corporation was a fraud upon it, since the promoters put in the property at a price greatly in excess of the price agreed upon in the options, without disclosing that fact to the corporation.[5]

[5] Erlanger *v.* Sombrero Phosphate Co., 3 App. Cas. 1218; Yale Gas Stove Co. *v.* Wilcox, 64 Conn. 101, 29 Atl. R. 303; Wardell *v.* Union Pac. Ry. Co., 103 U. S. 651.

Even if such a disclosure had been made, the proposition was not submitted to an independent board of directors.[6]

Although at the time the transactions were carried through the promoters and their employees were the only ones interested in the corporation, the purpose of the business was to deceive the future stockholders and profit at their expense, and in consequence should be regarded as a fraud on the corporation which the receiver as its representative could attack.[7]

As far as the bonus stock is concerned the holders would be liable on authority of *Handley* v. *Stutz*,[8] the court holding that bonus stock issued with bonds, for the purpose of rehabilitating the impaired capital of a going corporation, will be treated fully paid, but stock distributed gratuitously to existing shareholders or to third persons for any purpose other than the rehabilitation of capital will be subject to assessment at the suit of creditors.[9] The same liberal rule is applied in case of reorganizations, or stock issued to pay debts.[10]

The principles just considered would not be decisive of the obligations of those defendants who do not stand in the relation of promoters or privies. The chief interest in the case arises out of this phase. It was urged by the defendants that the stock was in fact full paid since the $5,000,000 paid for the property was less than its real value properly estimated. It appears that the value fixed was arrived at by considering the maximum capacity of the mills involved in the purchase, the cost per ton of production, the enhanced price that could be obtained if competition were suppressed. The profits thus estimated when capitalized greatly exceeded the price at which the property was sold, and was sufficient to pay interest on the bonds, the dividends reserved on the preferred stock, and at least 15% on the common stock, besides providing a sinking fund of 1%. They also seek to justify the values fixed by the assertion, which is admitted by the court, that the practice of capitalizing prospective profits is a common practice, particularly in the state of New Jersey; that it was made in good faith, pursuant to such general custom. The statutes of New Jersey[11] provide "That the directors of any

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[6] Erlanger *v.* Sombrero Phosphate Co., supra.

[7] Cases cited supra. 1 Morawetz on Corporations (2nd Ed.), sec. 291; Alger on Promoters, sec. 83; Chandler *v.* Bacon, 30 Fed. R. 538.

[8] 139 U. S. 417.

[9] Handley *v.* Stutz, supra; Clark *v.* Baer, 139 U. S. 96; Memphis, etc., Ry. Co. *v.* Dow, 120 U. S. 287; Lake St. Elevated Co. *v.* Zeigler, 99 Fed. 114; Richardson Roller Mill Co. *v.* Farrell Foundry Co., 75 Fed. 554; Sioux City, etc., Ry. *v.* Manhattan Trust Co., 92 Fed. R. 428.

[10] See cases supra.

[11] General Statutes of New Jersey, p. 917, sec. 54; General Statutes of New Jersey, p. 952, sec. 213.

company, incorporated under this act, may purchase mines, manufactories or other property necessary for their business * * * and issue stock to the amount of value thereof, and the stock so issued shall be declared and taken to be full paid stock and not liable to any further call. Neither shall the holder be liable for any further payments under any of the provisions of this act. * * *" The same provision in substance is found in the constitutions or statutes of the several states. The proposition is stated by the court as follows: "The question which arises out of its ultimate analysis is whether, under our statute, above cited, it is competent and lawful to make up the valuation of the visible property to be purchased for stock issued by adding to the actual market value or cost of its reproduction a sum of money ascertained by the capitalization of the annual profits expected to be realized from a favorable marketing of the product of the company by a suppression of competition."

"The word property (as used in the statute) must be construed by its context, which refers to something visible and tangible, and necessary for the business, and the amount of stock to be issued, therefore, is limited to the value thereof; that is, to the value of that property."

The apparent exclusion in this construction of all forms of incorporeal property, as well as good will, which is an important and well recognized element of value, as incident to the sale of an established business,[12] is probably an inadvertence, since the court discusses the contention that the increased valuation in this case may be justified by and attributed to the item of good will, and holds that the good will of the various properties was actually covered by the terms of the original option, and covered by the price paid, and cannot now serve as the basis of an additional valuation, and further that the combined properties cannot be said to have any good will, in the proper sense of the term, since they had not been operated in conjunction, and had acquired no business relations or friends up to the time of the transfer to the corporation.

The court denies the good faith of a transaction which does not in any manner increase the intrinsic or practical value of the property, or in any way add to its productivity. The sole object of the promoter is to sell shares at more than their real value, and thereby secure a profit immediately in hand, and further to obtain a mercantile credit based on a large capital.

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[12] Washburn *v.* National Wall Paper Co., 81 Fed. R. 17.

The doctrine that purely prospective profits shall not be capitalized and exchanged for stock at par is a most salutary one. The evil results of such a policy of speculation are well exemplified in the principal case, not one of the optimistic hopes on which the overvaluation was predicated was realized, and the whole enterprise was shortly involved in ruin. Unfortunately the present case is but one of many conspicuous examples. Such practices are as disastrous economically as they are unsound legally. The propriety of allowing corporations to pay or exchange stock for property is universally recognized. No good reason can be suggested why a corporation should be compelled to go through the ceremony of receiving cash from a subscriber, and at once paying it back to him for property. Although the form is dispensed with, the value obtained from a sale of stock should on principle be the same whether paid in money or property.[13]

The principle applied by the courts in cases where future profits are sought to be recovered may be invoked in this connection. It is always permissible in such cases to show the past profits of a business for a reasonable time next preceding the time of injury.[14] In such a case there is an established basis of fact from which it is safe to make deductions as to the immediate future. Where that basis is lacking the courts refuse to allow the introduction of evidence as to possible profits on the ground that it is uncertain and speculative.[15]

In fixing the value of the good will, it is customary and proper to consider the past and present earning power of the property as conducted, and the income arising over and above the fixed rent will in general represent fairly the value of the good will.

In the principal case this basis of fact is not present, the profits are all predicated on contingencies that may not arise. No allowance is made for possible adverse conditions. Under such circumstances a court charged with enforcing the letter and spirit of a statute designed to secure the contribution of value, whether it be money or property, equal to the par value of stock should at least apply the rule of law in damages, and refuse to consider pure speculation property within the meaning of the law.

An examination of the statutes of the various states indicates a common purpose to protect the public and the creditors against fictitious stock, the most common provisions being that stock is payable in money, labor or property, actually received: property received at a fair valuation; actual value in money—or property esti-

[13] Gamble *v.* Queens Co. Water Co., 123 N. Y. 91, at 107.
[14] Chapman *v.* Kerley, 49 Ill. 211.
[15] Masterton *v.* Mt. Vernon, 58 N. Y. 391; Home Machine Co. *v.* Bryson, 44 Ia. 159; Brigham *v.* Carlisle, 78 Ala. 243.

mated at its full money value equal to par value of stock. The courts in construing these provisions have properly recognized that the officers of the corporation are in a better position to pass on the value of property than the court itself, and have accordingly permitted considerable latitude to the directors in fixing values.

The court's function in such matters is the same as when passing on the verdict of a jury. Where the property exchanged for stock has a recognized value, a comparatively slight variation will raise the implication of bad faith. Where the property is of such a nature that it has not only a present value, but a potential value, as well, as mines, patents, oil lands, etc., it is extremely difficult to say that the value fixed by the parties is fraudulent. Text writers have attempted to group the decisions of the courts under three general rules: the true value rule, the good faith rule, and the speculative value rule.[16]

If the function of the court is as indicated above, it is difficult to sustain the true value rule, since its application would seem to involve an examination into the actual value of the property without reference to the valuation made by the directors. On the other hand, the good faith rule gives due consideration to the directors' valuation, and the court in applying it, will not declare the valuation fraudulent unless it is so obviously at variance with the reasonable value as to impugn the good faith of the parties making it.

The good faith rule and the true value rule really come to the same thing, when the property involved has a well recognized market value—in such cases a comparatively slight increase over such recognized value will challenge the good faith of the directors and shareholders. Good faith is then a relative term, depending on the circumstances of the particular case. In practically every case other circumstances are present which aid the court in its solution. The court will consider the steps taken by the directors to investigate the real value of the property: the relation which the directors bear to the vendors of the property, whether the vendors stand in a fiduciary relation to the corporation.[17]

The majority of the courts unquestionably follow the case of *Coit* v. *The Gold Amalgamating Co.*,[18] which lays down the rule that actual fraud must be shown in order to establish a fictitious issue of stock. The doctrine thus announced is the basis of the good faith rule, namely, a conscious or gross overvaluation by the directors

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[16] Frost on Incorporations, sec. 103, et seq.

[17] Taylor *v.* Walker, 117 Fed. R. 732; Taylor *v.* Cummings, 127 Fed. R. 108.

[18] 119 U. S. 343.

will raise the implication of fraud.[19] In favor of the so-called speculative value rule it is urged that unless corporations are permitted to take over property at its potential rather than its intrinsic value it will be impossible to launch many important enterprises, the success of which depends upon the development of mineral or oil lands, or patents, the value of which is not susceptible of present demonstration but depending on future development. No one is injured thereby, since the public knows there is usually no relation between the value of the property and the par value of the shares. It is a speculative venture, and speculative valuation should be allowed.[20]

The same argument has been advanced by the courts. In the case of *In re South Mountain Mining Co.*[21] the court, dealing with a mining company, says that the amount of stock issued to take over property of that character is purely arbitrary, and neither bears nor is intended to bear the slightest relation to the value of the property. A distinguished writer on corporations has given the weight of his authority to the same view as far as mining companies are concerned.[22]

In *Kelly* v. *Clark*,[23] the Supreme Court of Montana in dealing with a mining case strongly dissents from the above view, declaring that the real or supposed necessities of business and the common understanding of the public cannot prevail in the face of a statute which forbids the issue of stock except for money or property actually received. No exception is made in favor of mining companies. The views of the Montana court prevail in other jurisdictions also.[24]

The same reasoning that would make an exception of mining companies would logically exempt other forms of speculative property also. It is difficult to conceive of any case of business exigency that will justify the arbitrary valuation of any sort of property given in exchange for stock. Meritorious enterprises can find the necessary capital without resorting to a practice which, after all is said, is for the purpose of selling shares at more than their real worth, usually fattening the purse of the promoter at the expense of the stock-

[19] Fogg *v.* Blair, 139 U. S. 118; Camden *v.* Stuart, 144 U. S. 104; Lloyd *v.* Preston, 146 U. S. 630; Northwestern Mu. Life Ins. Co. *v.* Cotton Exchange Real Estate Co., 46 Fed. R. 22.

[20] Frost on Incorporations, p. 135 et seq.

[21] 5 Fed. R. 403; 14 Fed. R. 347 [on appeal].

[22] 2 Morawetz on Corporations, sec. 830.

[23] 21 Mont. 291.

[24] Salt Lake Hardware Co. *v.* Tintic Milling Co., 13 Utah 423, 45 Pac. 200; Gogebic Investment Co. *v.* Iron Chief Mining Co., 78 Wis. 427; Hodges *v.* Mining Co., 9 Ore. 200; Thayer *v.* El Pomo Mining Co., 40 Ill. App. 344.

holders and the creditors. Even if the speculative value rule were recognized in terms it would not help the defendants in the principal case, since the property involved cannot be strictly regarded as speculative.

The rule forbidding the capitalization of speculative profits does not in the least interfere with legitimate enterprise or prevent the sale of incorporeal rights or good will. It does not in reality question the good faith rule generally accepted. It is in substance an application of that rule stated in a different form.

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